

UNITED STATES DISTRICT COURT
DISTRICT OF NEVADA

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**MINGBO CAI, Individually and On Behalf of
All Others Similarly Situated,**

Case No. 2:18-cv-01471-JCM-VCF

V

Plaintiffs,

ORDER

SWITCH, INC., *et al.*,

Defendants.

14 Presently before the court is Magistrate Judge Cam Ferenbach's report and
15 recommendation. (ECF No. 88). Plaintiff Oscar Farach filed an objection (ECF No. 89), to
16 which defendants Switch, Inc. ("Switch"); Rob Roy, Gabriel Nacht, Zareh Sarrafian, Donald
17 Snyder, Tom Thomas, and Bryan Wolf (collectively "defendants") responded (ECF No. 90).

18 Also before the court is defendants' motion to strike. (ECF No. 63). Farach filed a
19 response (ECF No. 79), to which defendants replied (ECF No. 85).

20 Also before the court is defendants' motion to dismiss. (ECF No. 60). Farach filed a
21 response (ECF No. 78), to which defendants replied (ECF No. 84).

22 | I. Facts

23 Farach has brought forth this putative securities class action challenging Switch's failure
24 to include certain information in the registration statement and prospectus that Switch issued in
25 connection with its initial public offering ("IPO"). (ECF No. 58). The amended complaint
26 contains the following allegations:

27 Switch is a Nevada corporation that hosts data centers and provides to its customers
28 colocation, telecommunications, cloud, and content ecosystems services. *Id.* Most of Switch's

1 revenue comes from colocation services, which amounted to 81.4% of total revenue in fiscal year
2 2016. *Id.* Colocation services are rental agreements where customers lease information
3 technology infrastructure, such as servers and storage hardware, to avoid the cost of establishing
4 and maintaining their own facilities. *Id.*

5 Roy was at all relevant times to this lawsuit Switch's chief executive officer ("CEO") and
6 chairman of the board of directors. *Id.* In 2000, Roy founded Switch and began building a data
7 center in Las Vegas near another data center that Enron Corporation ("Enron") was constructing.
8 *Id.* In 2002, Enron declared bankruptcy a week before it planned to open its data center. *Id.*
9 Roy subsequently acquired the state-of-the-art facility at a steep discount, which allowed Switch
10 to transfer massive amounts of data at below market rates. *Id.*

11 Although Switch established other data centers over the years, the Las Vegas data center
12 remained as the company's primary source of revenue. *Id.* Several market advantages, in
13 addition to Roy's shrewd acquisition of the facility, are responsible for this success. *Id.* The Las
14 Vegas data center is part of a fiber optic network that connects to Switch's Tahoe/Reno data
15 center, San Francisco, and Los Angeles. *Id.* Switch also purchases power in Nevada at low
16 costs because it is authorized to directly deal with the national power market. *Id.* Lastly, Nevada
17 does not impose a corporate income tax and is adjacent to California, which has a large demand
18 for information technology services. *Id.*

19 In 2017, Switch began changing its sales strategy to focus on selling hybrid cloud
20 solutions, which would allow customers to move larger technology operations to Switch's data
21 centers. *Id.* This new strategy presented a significant risk of lengthening sales timelines because
22 it involved new complications and required engineering. *Id.* Switch did not disclose this shift in
23 strategy and that it would likely have an adverse effect on revenue. *Id.*

24 On June 13, 2017, Switch registered as a corporation so that it can issue class A common
25 stock in an IPO. *Id.* On September 8, 2017, Switch filed the registration statement for its IPO
26 with the Securities and Exchange Commission ("SEC") and, on September 25, 2017, Switch
27 amended the registration statement and the prospectus therein. *Id.* The registration statement
28 included Switch's offer to sell 31,250,000 shares, with an option for the underwriters to purchase

1 an additional 4,687,400 shares, at \$17.00 per share. *Id.*

2 Switch discussed in the registration statement its growth strategy, which involved
3 developing new facilities in Grand Rapids, Michigan and Atlanta, Georgia. *Id.* However, the
4 registration statement did not disclose facts explaining that these new facilities lacked the unique
5 market advantages that made the Las Vegas data center successful. *Id.* The registration
6 statement also failed to disclose that Switch had changed its sales strategy to focus on hybrid
7 cloud solutions. *Id.* Lastly, the registration statement reported that Switch's recurring revenue
8 for the first six months of 2017 was \$177,213,000.00. *Id.* This figure included \$9,400,000.00
9 for colocation services that eBay would use in 2018. *Id.* Had Switch not including this amount
10 in the recurring revenue, Switch's revenue growth would have been 13% rather than 20%. *Id.*

11 On October 6, 2017, shares in Switch began trading on the New York Stock Exchange.
12 *Id.* Six days later, Switch announced the closing of its IPO and that the underwriters executed
13 their option to purchase an additional 4,687,400 shares. *Id.* In total, Switch sold 35,937,500
14 shares of class A common stock and received \$577,300,000.00 in proceeds. *Id.* Switch also
15 incurred \$4,100,000.00 in offering expenses. *Id.*

16 On August 13, 2018, Switch issued a press release in which the company lowered its
17 revenue guidance for the rest of the year. *Id.* Switch attributed this decrease in expected revenue
18 to its shift in sales strategy towards selling hybrid cloud solutions. *Id.* Switch's chief financial
19 officer ("CFO") and president, Nacht and Thomas Morton respectively, also stated that Switch
20 had been working on hybrid cloud solutions for a while and that the company was not actually
21 changing its sales approach. *Id.* Analysts critiqued the sales strategy for not being as presented
22 in the IPO materials and that the deviation in sales figures was unexpected. *Id.* The next day,
23 Switch's stock dropped 22.3%—from \$13.98 per share to \$10.85 per share. *Id.*

24 In sum, the alleged misleading statements and omissions in the registration statement
25 allowed Switch to sell its class A common stock at \$17.00 per share. *Id.* Since the IPO,
26 Switch's stock price has decreased to approximately \$9 per share, over a 47% drop. *Id.* Farach
27 alleges that, had Switch filed a registration statement with adequate disclosures, the purported
28 class would not have incurred substantial losses in the form of decreased stock prices. *Id.*

1 **II. Procedural History**

2 On June 11, 2018, plaintiff Mingbo Cai initiated this action. (ECF No. 1). In the
3 amended complaint, lead plaintiff Farach alleges two causes of action: (1) violation of section 11
4 of the Securities Act of 1933 (“Securities Act”), 15 U.S.C. § 77k, and (2) section 15 of the
5 Securities Act, 15 U.S.C. § 77o. (ECF No. 58).

6 Now, defendants move to dismiss the amended complaint under Federal Rule of Civil
7 Procedure 12(b)(6) and strike paragraphs 45, 46, 56, and 65, and footnotes 4 and 7, from the
8 amended complaint. (ECF Nos. 60, 63). Magistrate Judge Ferenbach recommends striking
9 paragraphs 45 and 46, and footnotes 3, 4, and 7. (ECF No. 88).

10 **III. Legal Standard**

11 *a. Report and recommendation*

12 This court “may accept, reject, or modify, in whole or in part, the findings or
13 recommendations made by the magistrate.” 28 U.S.C. § 636(b)(1). Where a party timely objects
14 to a magistrate judge’s report and recommendation, then the court is required to “make a de novo
15 determination of those portions of the [report and recommendation] to which objection is made.”
16 28 U.S.C. § 636(b)(1).

17 Where a party fails to object, however, the court is not required to conduct “any review at
18 all . . . of any issue that is not the subject of an objection.” *Thomas v. Arn*, 474 U.S. 140, 149
19 (1985). Indeed, the Ninth Circuit has recognized that a district court is not required to review a
20 magistrate judge’s report and recommendation where no objections have been filed. *See United*
21 *States v. Reyna-Tapia*, 328 F.3d 1114 (9th Cir. 2003) (disregarding the standard of review
22 employed by the district court when reviewing a report and recommendation to which no
23 objections were made).

24 *b. Failure to state a claim*

25 A court may dismiss a complaint for “failure to state a claim upon which relief can be
26 granted.” Fed. R. Civ. P. 12(b)(6). A properly pled complaint must provide “[a] short and plain
27 statement of the claim showing that the pleader is entitled to relief.” Fed. R. Civ. P. 8(a)(2); *Bell*
28 *Atlantic Corp. v. Twombly*, 550 U.S. 544, 555 (2007). While Rule 8 does not require detailed

1 factual allegations, it demands “more than labels and conclusions” or a “formulaic recitation of
2 the elements of a cause of action.” *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (citation
3 omitted).

4 “Factual allegations must be enough to rise above the speculative level.” *Twombly*, 550
5 U.S. at 555. Thus, to survive a motion to dismiss, a complaint must contain sufficient factual
6 matter to “state a claim to relief that is plausible on its face.” *Iqbal*, 556 U.S. 662, 678 (citation
7 omitted).

8 In *Iqbal*, the Supreme Court clarified the two-step approach district courts are to apply
9 when considering motions to dismiss. First, the court must accept as true all well-pled factual
10 allegations in the complaint; however, legal conclusions are not entitled to the assumption of
11 truth. *Id.* at 678–79. Mere recitals of the elements of a cause of action, supported only by
12 conclusory statements, do not suffice. *Id.* at 678.

13 Second, the court must consider whether the factual allegations in the complaint allege a
14 plausible claim for relief. *Id.* at 679. A claim is facially plausible when the plaintiff’s complaint
15 alleges facts that allow the court to draw a reasonable inference that the defendant is liable for
16 the alleged misconduct. *Id.* at 678.

17 Where the complaint does not permit the court to infer more than the mere possibility of
18 misconduct, the complaint has “alleged—but not shown—that the pleader is entitled to relief.”
19 *Id.* (internal quotation marks omitted). When the allegations in a complaint have not crossed the
20 line from conceivable to plausible, plaintiff’s claim must be dismissed. *Twombly*, 550 U.S. at
21 570.

22 The Ninth Circuit addressed post-*Iqbal* pleading standards in *Starr v. Baca*, 652 F.3d
23 1202, 1216 (9th Cir. 2011). The *Starr* court stated, in relevant part:

24 First, to be entitled to the presumption of truth, allegations in a complaint or
25 counterclaim may not simply recite the elements of a cause of action, but must
26 contain sufficient allegations of underlying facts to give fair notice and to enable
27 the opposing party to defend itself effectively. Second, the factual allegations that
are taken as true must plausibly suggest an entitlement to relief, such that it is not
unfair to require the opposing party to be subjected to the expense of discovery and
continued litigation.

28 *Id.*

1 **IV. Discussion**

2 Two motions and one report and recommendation are pending before the court. First, the
3 court will adopt in part and reject in part Magistrate Judge Ferenbach's recommendation and
4 strike footnotes 4 and 7 from the amended complaint. Second, the court will grant in part and
5 deny in part defendants' motion to dismiss.

6 *a. Report and recommendation*

7 Magistrate Judge Ferenbach recommends that the court strike paragraphs 45 and 46, and
8 footnotes 3, 4, and 7, from the amended complaint. (ECF No. 88). Farach filed a timely
9 objection to the report and recommendation. (ECF No. 89). Therefore, the court engages in a *de*
10 *novo* review to determine whether to adopt the magistrate judge's recommendation. *See* 28
11 U.S.C. § 636(b)(1).

12 Federal Rule of Civil Procedure 12(f) provides that “[t]he court may strike from a
13 pleading an insufficient defense or any redundant, immaterial, impertinent, or scandalous
14 matter.” Fed. R. Civ. P. 12(f). “The function of a 12(f) motion to strike is to avoid the
15 expenditure of time and money that must arise from litigating spurious issues by dispensing with
16 those issues prior to trial[.]” *Whittlestone, Inc. v. Handi-Craft Co.*, 618 F.3d 970, 973 (9th Cir.
17 2010).

18 Farach alleges in paragraph 45 and footnote 3 that the IPO gave Roy complete control of
19 Switch by incorporating the company as a C-corporation where class A common stock yields
20 only a 5.6% voting interest. (ECF No. 58). In contrast, Roy's class C shares have 10-1 voting
21 rights, giving him a 67% voting power over the company. *Id.* Farach alleges in paragraph 46
22 that Roy and Morton were highly compensated for the IPO. *Id.* Roy allegedly received
23 \$94,600,000.00 and his stake in Switch after the IPO was \$875,000,000.00. *Id.* Morton
24 allegedly received \$12,000,000.00. *Id.*

25 “Section 15(a) of the 1933 Securities Act imposes joint and several liability upon every
26 person who controls any person liable under sections 11 or 12.” *In re Daou Sys., Inc.*, 411 F.3d
27 1006, 1029 (9th Cir. 2005) (citing 15 U.S.C. § 77o). The facts alleged in paragraphs 45 and 46,
28 and footnote 3, show that Roy had control over the IPO process because Roy structured the IPO

1 in a manner that gave him a controlling stake in the company and significant financial benefits.
2 Thus, because these allegations are material to Farach's section 15 claim and do not substantially
3 raise other Rule 12(f) concerns, the court will not strike paragraphs 45 and 46, and footnote 3, of
4 the amended complaint. *See Whittlestone*, 618 F.3d at 973–75.

5 Farach alleges in footnotes 4 and 7 that Switch's history of weak disclosures limit
6 transparency and that Roy never participated in an investor earnings call despite being the CEO
7 and controlling shareholder of Switch. (ECF No. 58). Farach generally remarks that the court
8 should not strike these footnotes because they do not waste resources or prejudice the
9 defendants. (ECF No. 89). However, the heart of the magistrate judge's finding is that these
10 footnotes are all but irrelevant to determining whether defendants committed a section 11
11 violation. *See* (ECF No. 88). The court agrees with the magistrate judge. Switch's history of
12 disclosure and Roy's participation in investor earnings calls are too attenuated from any alleged
13 misleading statements or material omissions in the registration statement to survive a Rule 12(f)
14 motion.

15 The magistrate judge also recommends that the court deny defendants' Rule 12(f) motion
16 as it pertains to paragraphs 56 and 65. *Id.* Defendants have not objected to the recommendation.
17 Nevertheless, the court conducted a *de novo* review and finds good cause to adopt the magistrate
18 judge's finding as it pertains to paragraphs 56 and 65.

19 b. *Failure to state a claim*

20 Defendants move to dismiss Farach's section 11 and section 15 claims. (ECF No. 60).
21 The court addresses each in turn.

22 i. *Section 11 of the Securities Act*

23 Section 11 of the Securities Act imposes liability on an issuer of a security if the
24 corresponding registration statement "contained an untrue statement of material fact or omitted
25 to state a material fact . . . necessary to make the statements therein not misleading[.]" 15 U.S.C.
26 § 77k(a). To state a section 11 claim, a plaintiff must allege "(1) that the registration statement
27 contained an omission or misrepresentation, and (2) that the omission or misrepresentation was
28 material, that is, it would have misled a reasonable investor about the nature of his or her

1 investment.” *Rubke v. Capitol Bancorp Ltd*, 551 F.3d 1156, 1161 (9th Cir. 2009) (quotation
2 marks and citation omitted).

3 A heightened pleading standard does not typically apply to section 11 claims. *Id.*
4 However, when the complaint sounds in fraud, plaintiffs must allege their causes of action with
5 particularity under Federal Rule of Civil Procedure 9(b). *In re Rigel Pharm. Inc. Sec. Litig.*, 697
6 F.3d 869, 885 (9th Cir. 2012). Farach alleges that the defendants negligently signed the
7 registration statement, which contained material misrepresentations and omissions. (ECF No.
8 58). A securities claim based on negligence does not sound in fraud because it does not rely on a
9 “unified course of fraudulent conduct[.]” *Rubke*, 551 F.3d at 1161. Therefore, the notice
10 pleading standard under Rule 8(a) applies to Farach’s section 11 claim.

11 Farach alleges that defendants violated section 11 by (1) failing to disclose that Switch
12 implemented a new sales strategy that presented a significant risk of adversely affecting revenue;
13 (2) failing to disclose unique characteristics and circumstances of the Las Vegas data center that
14 did not exist at other locations, making it highly unlikely that Switch could replicate the success
15 of the Las Vegas data center; and (3) misrepresenting Switch’s revenue by improperly including
16 \$9,400,000.00 for services that eBay would not use until the next fiscal year. (ECF No. 58).

17 *1. Switch’s new sales strategy*

18 Regulation S-K governs the non-financial statement portion of registration statements.
19 17 C.F.R. § 229.10. Item 303 of regulation S-K requires an issuer of a security to disclose “any
20 known trends or uncertainties that have had or that the registrant reasonably expects will have a
21 material favorable or unfavorable impact on net sales or revenues or income from continuing
22 operation.” 17 C.F.R. § 229.303(a)(3)(ii). Failure to comply with item 303 constitutes a
23 violation of section 11. *Steckman v. Hart Brewing*, 143 F.3d 1293, 1296 (9th Cir. 1998).

24 Defendants note that the registration statement discussed that hybrid cloud solutions are a
25 remarkable growth opportunity and that Switch expects to take advantage of that opportunity.
26 (ECF No. 60). However, the sections which defendants quote do not indicate that Switch had
27 already changed its sales strategy to focus on hybrid cloud solutions. *See id.* Based on the
28 allegations in the complaint, Switch’s strategy presented a serious risk of diminishing revenue

1 due to new complications and required engineering. (ECF No. 58). Therefore, the complaint
2 sufficiently alleges facts from which a reasonable jury could find that Switch violated Item 303
3 by failing to disclose its new sales strategy. *See Durning v. First Boston Corp.*, 815 F.3d 1265,
4 1268 (9th Cir. 1987) (“. . . adequacy of disclosure is normally a jury question.”).

5 Similarly, item 503 of regulation S-K requires “a discussion of the most significant
6 factors that make the offering speculative or risky.” 17 C.F.R. § 229.503(c). The registration
7 statement must include an explanation of “how the risk affects the issuer or the securities being
8 offered.” *Id.* Although the prospectus includes over thirty pages of risk disclosures, defendants
9 identify only general statements that the company faced risks associated with long selling and
10 implementation cycles. (ECF Nos. 60, 62-1). These kinds of boilerplate risk factors do not
11 satisfy the requirements set forth in item 503. *See Plain English Disclosure, Securities Act*
12 *Release No. 33-7497*, 63 Fed. Reg. 6370-01, 1998 WL 44199 (Feb. 6, 1998).

13 The court is not aware of any language in the registration statement that indicates the
14 specific risks arising from Switch’s new sales strategy. *See* (ECF No. 62-1). Further, Farach
15 alleges that once Switch disclosed its sales strategy along with its potential effects on revenue,
16 Switch’s stock price dropped by 22.3%. (ECF No. 58). This is precisely the type of risk that
17 item 503 requires issuers of securities to disclose. Thus, Farach has plausibly pleaded that
18 Switch violated item 503 by failing to discuss and explain the risks of its new sales strategy.

19 *2. Switch’s ability to replicate the success of the Las Vegas data center*

20 Defendants argue that they did not mislead investors about the prospects for the Grand
21 Rapids and Atlanta data centers because the registration statement warned that revenue from the
22 new data centers was uncertain. (ECF No. 60). These warnings mentioned that almost all of
23 Switch’s revenue comes from the Las Vegas data center and that the new data centers presented
24 greater risk because the demand in those markets may not support the new facilities. *See id.* The
25 court agrees.

26 Farach does not allege in the complaint or identify in his response that any portion of the
27 registration statement forecasted that the Grand Rapids and Atlanta data centers would have a
28 similar degree of success as the Las Vegas data center. (ECF Nos. 58, 78). Instead, the

1 registration statement discloses Switch’s growth strategy and discusses the risks of the growth
2 strategy without comparison to the Las Vegas facility. (ECF No. 62-1). These representations
3 did not mislead investors into believing that the new data centers would replicate the success of
4 the Las Vegas data center because “skilled investors are aware that a corporation’s performance .
5 . . in a new market is unlikely to replicate past successes.” *In re Verifone Sec. Litig.*, 784 F.
6 Supp. 1471, 1484 (9th Cir. 1992).

7 Further, defendants aptly note that the registration statement explains that the Las Vegas
8 data center generates almost all of Switch’s revenue and that the new data centers may not be
9 profitable due to various market risks. (ECF No. 62-1). These statements expressly distinguish
10 the market conditions for the new data centers from the market conditions in Las Vegas. Thus,
11 any disclosures on the unique market advantages in Las Vegas would not have caused a
12 reasonable investor to think differently about the nature of his or her investment. *See Rubke*, 551
13 F.3d at 1161.

14 Accordingly, Farach has failed to plead that defendants’ violated section 11 by
15 misleading investors into believing that the new data centers would replicate the success of the
16 Las Vegas data center.

17 *3. Switch’s alleged misrepresentation of revenue*

18 Switch’s registration statement included \$9,400,000.00 for colocation services with eBay
19 in its recurring revenue report for the first six months of 2017. (ECF No. 62-1). Farach argues
20 that Switch should not have included this amount in the revenue report because eBay was going
21 to use the corresponding colocation services in 2018. (ECF Nos. 58, 78). Farach further argues
22 that this misrepresentation was material because it increased Switch’s revenue growth from 13%
23 to 20%. *Id.*

24 Farach has not provided and the court is not aware of any authority precluding issuers of
25 securities from including amounts that customers are contractually obligated to pay in recurring
26 revenue reports. Moreover, it is irrelevant that eBay was not going to use colocation services
27 under the contract until 2018 because eBay became obligated to pay for the licensed space in the
28 first six months of 2017. *See* (ECF Nos. 58, 60). Thus, Farach has failed to allege a concrete

1 falsehood or omission in the recurring revenue report and his section 11 claim with respect to the
2 eBay contract cannot succeed.

3 *ii. Section 15 of the Securities Act*

4 Section 15 of the Securities Act provides that “[e]very person who . . . controls any
5 person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with
6 and to the same extent as the controlled person[.]” 15 U.S.C. § 77o. To state a section 15 claim,
7 a plaintiff must allege (1) a primary violation of the Securities Act and (2) that the defendant
8 controlled the primary violator. 15 U.S.C. § 77o; *In re Rigel Pharms., Inc. Sec. Litig.*, 697 F.3d
9 869, 886 (9th Cir. 2012).

10 Defendants argue that Farach has failed to state a section 15 claim because he has not
11 alleged a primary violation of the Securities Act. (ECF No. 60). However, as the court
12 explained in section VI(b)(i)(1), Farach has plausibly pleaded that defendants violated section 11
13 by failing to disclose that Switch had implemented a new sales strategy and the risks arising from
14 that strategy. Therefore, the court will not dismiss Farach’s section 15 claim.

15 **V. Conclusion**

16 The court will adopt in part and reject in part Magistrate Judge Ferenbach’s
17 recommendation and strike only footnotes 4 and 7 from the amended complaint. The court will
18 also dismiss Farach’s section 11 claim as it pertains to (1) misleading investors that the new data
19 centers would replicate the success of the Las Vegas data center and (2) including the eBay
20 contract in the recurring revenue report for the first six months of 2017.

21 Accordingly,

22 IT IS HEREBY ORDERED, ADJUDGED, and DECREED that Magistrate Judge
23 Ferenbach’s report and recommendation (ECF No. 88) be, and the same hereby is, ADOPTED in
24 part and REJECTED in part, consistent with the foregoing.

25 IT IS FURTHER ORDERED that defendants’ motion to strike (ECF No. 63) be, and the
26 same hereby is, GRANTED in part and DENIED in part, consistent with the foregoing.

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1 IT IS FURTHER ORDERED that defendants' motion to dismiss (ECF No. 60) be, and
2 the same hereby is, GRANTED in part and DENIED in part, consistent with the foregoing.

3 DATED THIS 12th day of July 2019.

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5 *James C. Mahan*
6 JAMES C. MAHAN
7 UNITED STATES DISTRICT JUDGE
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